No. 84-264

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

CHEMICAL BANK,

Petitioner,

—against—

ARTHUR ANDERSEN & CO.,

Respondent.

MANUFACTURERS HANOVER TRUST COMPANY AND FIRST PENNSYLVANIA BANK, N.A.,

Petitioners,

—against—

ARTHUR ANDERSEN & CO.,

Respondent.

SECURITY PACIFIC NATIONAL BANK,

Petitioner,

—against—

ARTHUR ANDERSEN & CO.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION

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September 14, 1984

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QUESTIONS PRESENTED FOR REVIEW

1. Did Congress intend that the definitions of "security" in the Securities Act of 1933 (§ 2(1)) and the Securities Exchange Act of 1934 (§ 3(a)(10)), which provide that "unless the context otherwise requires . . . 'security' means any note," would cover a promissory note evidencing a loan made by a commercial bank to finance the borrower's current operations?

2. If such a promissory note is not a security, is there jurisdiction under the antifraud provisions of either of said Acts over an action by the lending bank to recover damages resulting from nonpayment of the bank loan, where stock was pledged as collateral for such loan, but there is no claim of misrepresentation or omission as to the stock pledged?

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BRIEF IN OPPOSITION

STATEMENT OF THE CASE

The four plaintiff banks (the "Banks") had a "borrowing relationship" with Frigitemp Corp. ("Frigitemp") which dated from at least 1971 (1ra).[1] Respondent Arthur Andersen & Co. ("Andersen") was the independent public accountant and auditor for Frigitemp.[2] Frigitemp went bankrupt in March, 1978, owing the Banks $12 million, plus interest (P 3).[3] The loans,

1. Relevant portions of the record are included in respondent's attached appendices and are cited " ra." References to the appendices annexed to the Petition are cited " a."
2. Pursuant to Rule 28.1, Andersen states that it is a partnership.
3. References to the petition for certiorari are cited "P ."

according to the Banks, were made on August 9, 1977 "in specific reliance upon Andersen's 1976 fiscal year-end audit, written certifications and oral representations that Frigitemp was an increasingly profitable and financially healthy company" (P 4). Andersen's opinion on Frigitemp's financial statements as of December31, 1976 was dated May 10, 1977 (9a).

The August 9, 1977 loans represented a restructuring of $15,500,000 of unpaid loans, together with a new $4,000,000 loan to Frigitemp's wholly-owned subsidiary Elsters, Inc. ("Elsters"), guaranteed by Frigitemp, with the guaranty secured by a pledge of all of the Elsters stock. Elsters was acquired by Frigitemp on January 11, 1977 (8a). "Andersen was not the auditor for Elsters and certified no financial statements for it" (11a, n.6).

The court of appeals opinion describes the loans which preceded the August 9, 1977 loans. Pursuant to "a line of credit up to $8 million," the Banks had "advanced $6.5 million to Frigitemp beginning in 1976. The loans were evidenced by Frigitemp's promissory notes maturing on July 1, 1977, and were secured by a pledge of Frigitemp customer notes receivable" (8a).

Pending such restructuring of Frigitemp's debt, "three banks in September, 1976 advanced $1.5 million evidenced by Frigitemp's one month promissory note to each bank; in October, 1976, they advanced an additional $3.5 million," with the $5 million total represented by promissory notes maturing on February 28, 1977. The loans were not paid when due; their "maturity was later extended to April 30, 1977" (8a-9a); again the notes were not paid, and they remained in default.

"In February, 1977, Frigitemp received an additional $4 million unsecured loan from all four banks, evidenced by promissory notes also maturing April 30, 1977" (9a). This $4 million loan was made only after Litton, which owed Frigitemp $11 million, of which $8,900,000 was recorded on Frigitemp's books as a receivable (9a), confirmed to Chemical that Frigitemp would be paid

$11 million "on or before February 28, 1977" so that this additional $4 million loan could be paid out of "the proceeds of [the] final settlement" with Litton (2ra).

These unsecured advances, totalling $9,000,000, made between September, 1976 and February, 1977, and the $6,500,000 advanced under the line of credit secured by Frigitemp's customer notes receivable, obviously could not have been made "in specific reliance upon Andersen's 1976 fiscal year-end audit," as stated in the petition (P 4), since Andersen's certification is dated May 10, 1977—long after these loans were made. Indeed, the $9,000,000 unsecured notes were in default on April 30, 1977, ten days before the date of Andersen's opinion on Frigitemp's allegedly fraudulent 1976 financial statements.

Andersen's May 10, 1977 opinion was qualified. Referring to the Litton receivable, the Andersen opinion stated that "'the ultimate realization of the claimed amounts [the Litton claim] recorded as of December 31, 1976, is not presently determinable'" (9a, n.4). Accordingly, Andersen's opinion was expressly made subject to settlement of the Litton claim (*id.*).

Following Andersen's May 10, 1977 qualified opinion, "the Banks decided to require Frigitemp to retain Worden & Risberg, management consultants, to report on Frigitemp and Elsters" (9a, n.3). Their report, dated June 28, 1977, stressed Frigitemp's "serious working capital deficit" (9a) and need for "approximately $4 million additional working capital to get through the current cash crunch it [was] experiencing" (10a). "One of the unsettling factors" (9a) was the non-payment of the Litton receivable, which was the basis for Andersen's qualified opinion warning as to the uncertainty of its collection (9a, n.4).

In short, the Banks had a borrower owing $15,500,000, which was in severe financial difficulties and which was counting on collecting an $8.9 million receivable. As the court of appeals recognized, based on Bank documents, "[t]he Banks had to decide whether to let Frigitemp go under or to make the loans needed to keep it afloat and hopefully to survive" (32a). The

Banks decided to make a new loan to Elsters of $4,000,000, secured by the Elsters stock.[4]

The petition confirms that "the Banks had provided the financing in the August, 1977 transaction based on their belief that without it Frigitemp would have gone bankrupt" (P6). Nevertheless, seeking to create a fraud case, the petition states that the Banks made the August 9, 1977 loans "in specific reliance upon Andersen's . . . representations that Frigitemp was an increasingly profitable and financially healthy company" (P 4).

As part of the restructuring of Frigitemp's debt to the Banks, the $9,000,000 unsecured notes in default were replaced by $9,000,000 of "Replacement Notes" issued on August 9, 1977, to mature on March 31, 1978. These carried interest tied to the prime rate, and are in the standard form of a one-page promissory note:

> FOR VALUE RECEIVED, FRIGITEMP CORP. promises to pay to the order of CHEMICAL BANK (the "Bank") at its offices located at 20 Pine Street, New York, New York, in lawful money of the United States of America, the principal amount of TWO MILLION SIX HUNDRED SIXTY-FIVE THOUSAND DOLLARS ($2,655,000) [sic] on or before March 31, 1978 (8ra).

The district court held "that the Replacement Notes are securities" (64a); the court of appeals unanimously held that they are not securities (24a).

The $6.5 million unpaid under the "line of credit" secured by Frigitemp's customer notes receivable was replaced by $6.5 million of Note Endorsements. The district court held that "the Note Endorsements are not securities" (59a); the court of appeals did not "consider [such] ruling" because the Banks had not "asked us to do so" (17a, n.10).

On August 9, 1977, the Frigitemp bank debt thus consisted of the Endorsement Notes, which replaced $6,500,000 of loans

4. The Banks' interrogatory answers state that "Elsters was considered to be a healthy and viable company, one of the strongest of Frigitemp's assets, which could be sold as a going concern in the event of a default by Frigitemp" (6ra).

secured by customers receivables, and the Replacement Notes, which replaced $9,000,000 of unsecured loans, for a total of $15,500,000.

As already noted, on January 11, 1977, Frigitemp acquired all the stock of Elsters. On August 9, 1977, the Banks made a new $4,000,000 loan to Elsters, thereby providing the funds urgently needed as " 'additional working capital to get through the current cash crunch' " (10a). This new loan was evidenced by Elsters' "promissory notes, dated August 8, 1977 maturing March 31, 1978; Frigitemp guaranteed these notes and pledged as security 100% of Elsters common stock" (10a-11a).[5]

The Banks' claim that they made the August, 1977 loans "in specific reliance upon Andersen's . . . representations that Frigitemp was an increasingly profitable and financially healthy company" (P 4) is belied by Frigitemp's defaults and need for an additional $4,000,000 "to keep it afloat" (32a).

In 1978, Andersen suspected that Frigitemp had engaged in "lapping" of accounts receivable, *i.e.*, the improper "allocation of payments on current to older receivables" (11a). Not satisfied with Frigitemp's explanation, Andersen advised by letter dated July 7, 1978 that Frigitemp's financial statements "may have been materially misstated and were not to be relied upon," and "withdrew all its prior certifications" (P 4-5). An auditor which suspects facts which might affect its opinion and does not receive a satisfactory explanation from management must withdraw its opinion and publicly advise that its reports should no longer be relied upon (*see* Montgomery, *Auditing* 751-52 (9th ed. 1975)). This is seized on as an admission of culpability, and triggers lawsuits against the auditor, which is often the only "deep pocket."

The foregoing, in brief summary, presents the facts relevant to the issue of jurisdiction under the federal securities laws.

5. The court of appeals found it "hard to see what added security a lender obtains by a pledge of the stock of the borrower when it already has a claim against the borrower's assets ranking prior to the stock" (33a, n.21; *see also* 35a, n.26).

REASONS FOR DENYING THE PETITION

This case presents neither special nor important reasons to grant review. There is no conflict in circuits as to whether a promissory note evidencing a loan made by a commercial bank to finance current operations of the borrower is a security. Six circuits have all held that such a note is not a security.

Also, there is no conflict in circuits as to whether a pledge of stock to secure a commercial bank loan can create jurisdiction under § 17(a) of the 1933 Act or § 10(b) of the 1934 Act and Rule 10b-5 thereunder, where there is no allegation of misrepresentation or omission as to the pledged stock. The decision below is the only one in which this question has even arisen. Nor is such decision in conflict with an applicable decision of this Court.

I.

A PROMISSORY NOTE EVIDENCING A LOAN MADE BY A COMMERCIAL BANK TO FINANCE CURRENT OPERATIONS OF A BORROWER IS NOT A SECURITY UNDER THE FEDERAL SECURITIES LAWS.

To give an investment tinge to the promissory notes, the petition describes them as "evidencing almost $20 million of advances in a major capital financing" (P 2) and bases "federal subject matter jurisdiction on the capital financing" (P 4). However, as the court of appeals emphasized, the case involves "notes evidencing loans by commercial banks for current operations" (24a; *see also* 9a, 23a). The district court held that "the notes had the essential characteristics of an instrument representing a commercial loan" (56a-57a).

The court of appeals decision is not in conflict with the decision of any federal court of appeals on the same matter. Prior to the decision below, five other circuits, namely, the fifth, sixth, seventh, ninth and eleventh, had held that promissory notes representing commercial bank loans are not securities.[6]

6. *See Bellah* v. *First National Bank*, 495 F.2d 1109, 1114 (5th Cir. 1974) (where "complaints are spawned by a commercial loan transaction, recourse must be had to state not federal courts"); *American Bank & Trust Co.* v. *Wallace*, 702 F.2d 93, 97 (6th Cir. 1983) (note given to

The district court concluded that the Replacement Notes are securities only because it felt bound by *Exchange National Bank* v. *Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976). In that case, in contrast with the notes in the instant case, the notes were "the equivalent of equity capital." There Judge Friendly's opinion, after giving six examples of notes that are not securities, stated in a dictum that "[w]hen a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) of the 1934 Act should generally be held to apply" (*id.* at 1137-38) (footnote omitted).

The district court held that the $6,500,000 Endorsement Notes "which were for a short term and which were secured by Frigitemp's customer notes receivable, bear a strong family resemblance to 'short-term notes secured by an assignment of accounts receivable'" -- one of Judge Friendly's six "examples" -- and

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a bank in a "commercial loan transaction was not a 'security'" because the bank "was not an 'investor'"); *Union Planters National Bank* v. *Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1185 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981) ("[t]he securities laws are not a panacea for commercial loans gone awry" and "[r]elief from the consequences of commercial transactions unwisely contracted must be found in another haven"); *C.N.S. Enterprises, Inc.* v. *G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1362 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975) (note for a commercial bank did not "represent anything beyond the borrowing of money"); *American Fletcher Mortgage Co.* v. *U.S. Steel Credit Corp.*, 635 F.2d 1247, 1254 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981) ("Congress did not intend to regulate commercial loan transactions that would have no impact on the securities markets"); *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252, 1260 (9th Cir. 1976) ("a note given to a bank in the course of a commercial financial transaction is not generally a security within the meaning of the federal securities acts"); *Kaye* v. *Pawnee Construction Co.*, 680 F.2d 1360, 1366 (11th Cir. 1982). The only second circuit decision involving jurisdiction as to commercial bank loans held that "an ordinary commercial loan transaction" does not involve the purchase or sale of securities. *Stirling* v. *Chemical Bank*, 382 F. Supp. 1146, 1151 (S.D.N.Y. 1974), *aff'd on the district court's opinion*, 516 F.2d 1396 (2d Cir. 1975) (per curiam). In cases not involving notes representing commercial bank loans, the third, eighth and tenth circuits, relying on the above-quoted decisions from other circuits, have also held that transactions of a commercial nature are not securities. *See Lino* v. *City Investing Co.*, 487 F.2d 689 (3d Cir. 1973); *Kansas State Bank* v. *Citizens Bank*, 737 F.2d 1490 (8th Cir. 1984); and *Zabriskie* v. *Lewis*, 507 F.2d 546 (10th Cir. 1974).

therefore are not securities (59a). But because the Replacement Notes "bear no resemblance to the examples delineated by Judge Friendly," it held that the Replacement Notes are securities (*id.*).

However, in the opinion below Judge Friendly made clear that his six "examples" in *Exchange National Bank* "were not graven in stone" (24a), and "simply add[ed] notes evidencing loans by commercial banks for current operations to the categories previously listed" (*id.*). Accordingly, the court of appeals unanimously held "that the Replacement Notes were not securities under § 10(b) of the 1934 Act or § 17(a) of the 1933 Act" (36a). The second circuit is now in complete accord with the five other circuits which have held that promissory notes evidencing commercial bank loans are not securities.[7] The petition recognizes such present unanimity among the circuits, stating that the opinion below "in effect adopted the test of other circuits holding that a 'note' is a security only when it evidences an 'investment' transaction" (P 26).

Finally, *Marine Bank* v. *Weaver*, 455 U.S. 551, 560 n.10 (1982), cited with approval Judge Wright's opinion in *Great Western Bank & Trust*, *supra*, in support of its statement that an "agreement, negotiated one-on-one by the parties, is not a security" (23a, n.14). In the case at bar, as the district court stated, "[t]he obligations evidenced by the notes and the underlying agreements resulted from months of negotiations between the parties and were tailored to meet the needs of both Frigitemp and the Banks" (56a).

The Banks argue that *Securities Industry Association* v. *Board of Governors*, 104 S. Ct. 2979 (1984), without even referring to the instant issue, in effect overruled by implication the decisions in six circuits which consistently held that a promissory note evidencing a commercial bank loan is not a security. However,

7. The court of appeals stated that "[w]e are impressed also by the Banks' failure to cite any appellate decision, despite Andersen's challenge to do so, in which a note evidencing a loan made by a commercial bank to finance current operations of a borrower has been held to constitute a security within the federal securities laws" (23a) (footnote omitted).

that case did not involve a promissory note evidencing a commercial loan made by a bank to a borrower, the terms of which were negotiated one-on-one. It involved the issue whether the prohibition in the Glass-Steagall Act against banks selling securities and notes in competition with investment bankers extends to commercial paper which banks market to investors in much the same manner as investment bankers market stock or debentures, without any direct contact between the investor and the issuer of the commercial paper. As this Court stated in that case, referring to the intent of Congress when it "enacted the Glass-Steagall Act," there is "considerable evidence to indicate that the ordinary meaning of the terms 'security' and 'note' as used by the 1933 Congress encompasses commercial paper" (104 S. Ct. at 2987). In contrast, as the courts have frequently emphasized, there is no suggestion in the extensive legislative history of the 1933 Act or the 1934 Act that Congress intended the term "security" to include a promissory note which evidences a commercial bank loan made to finance the current operations of a borrower.

This Court has made it clear that a decision under the Glass-Steagall Act has no relationship to the securities laws, which have a different legislative history and different underlying policies. *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148, 157 (1976):

> The 1934 Act was enacted primarily to halt securities fraud, not to regulate banks. Indeed, banks were specifically exempted from many provisions of the securities laws, and Congress almost contemporaneously enacted other specific legislation dealing with the problems arising from banks' involvement in the security business. (Footnotes omitted.)[8]

8. It has long been recognized that the "security" definition under the federal securities laws is not the same as under the Glass-Steagall Act. As stated in *New York Stock Exchange, Inc.* v. *Smith*, 404 F. Supp. 1091, 1101 (D.D.C. 1975), *vacated on other grounds*, 562 F.2d 736 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 942 (1978), "[t]he Securities Act has a different legislative history and different underlying policies from the Glass-Steagall Act."

II.

FRIGITEMP'S PLEDGE OF THE ELSTERS STOCK DOES NOT CREATE JURISDICTION UNDER THE FEDERAL SECURITIES LAWS, SINCE THERE WERE NO ALLEGATIONS OF MISREPRESENTATION OR OMISSION AS TO SUCH STOCK.

There is no conflict in circuits as to the issue of jurisdiction based on the pledge of the Elsters stock. Since this issue here arises for the first time in the 50-year history of the federal securities laws, it does not present "an important question of federal law which has not been, but should be, settled by this Court" (Sup. Ct. R. 17.1(c)). Nor, as the petition seeks to establish, is the court of appeals decision "in conflict with applicable decisions of this Court" (*id.*).

Rubin v. *United States*, 449 U.S. 424, 426 (1981), held that the pledge of stock in that case was equivalent to a sale and gave rise to jurisdiction under the securities laws because "[t]he stocks were represented as being good, marketable, and unrestricted and valued at a total of approximately $1.7 million; in fact, they were practically worthless" (footnote omitted). A number of fraudulent acts were employed to show substantial value for the stock, such as arranging for "fictitious quotations to appear in a service reporting over-the-counter transactions" and "fictitious advertisement" (*id.* at 426-27). However, *Rubin* noted that "[t]he misrepresentations at issue in this case related to the stocks themselves .... Thus, we need not decide whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of § 17(a)" (*id.* at 429 n.6).

In the case at bar, "Andersen is not charged with having made or aided or abetted the making of any false representations about the Elsters stock" (36a, n.26). Also, petitioner Chemical Bank conceded " 'that it had no facts to support' " an assertion " 'that any information it received as to the business or financial condition of Elsters, Inc. was in any respect untrue or misleading or omitted to state any fact necessary to make such information not untrue or misleading' " (29a, n.18). And, as already noted,

"Andersen was not the auditor for Elsters and certified no financial statements for it" (11a, n.6).

In August, 1977 the Banks decided that, in order "to keep it [Frigitemp] afloat and hopefully to survive" (32a), they would make a new $4,000,000 loan to Elsters secured by a pledge of 100% of the Elsters stock.[9] The anomaly in the Banks' position that the pledge of Elsters stock to secure the new $4 million loan to Elsters can support jurisdiction was aptly stated in the majority opinion below:

> We cannot believe that if a person misrepresents his financial condition in order to borrow $100,000 from a bank to which he gives a one month note partially secured by a pledge of GM stock, the case comes within § 10(b) and Rule 10b-5, although but for the pledge it would not. Yet this seems the inevitable consequence of the Banks' position here.... It would be anomalous to hold that commercial bank loans procured by fraud are generally not within § 10(b) and Rule 10b-5, but that they become so, even though of a sort that no one would have considered to constitute a security, if collateralized with a security, although no misrepresentation was made with respect to the latter (35a-36a) (footnote omitted).[10]

The Banks do not appear to dispute such view if the stock pledged had been General Motors because it is "one of our nation's largest and strongest companies," and its stock "has an immediately ascertainable, realizable and liquid value," whereas Elsters was "a small, nonpublic company whose stock had no

9. As the opinion below states, after Andersen's May 10, 1977 opinion, the Banks required Frigitemp to retain outside consultants, who reported on June 28, 1977 that "Frigitemp 'needed approximately $4 million additional working capital to get through the current cash crunch'" (9a, n.3; 10a).

10. An aspect of the Banks' position which the court of appeals found "even more anomalous" is that the pledge of Elsters stock to secure the new $4 million loan also created jurisdiction over the $15,500,000 loans evidenced by the Note Endorsements and the Replacement Notes "in which no security played a part" (36a). And in this connection the court of appeals might have also noted that the Note Endorsements and Replacement Notes merely restructured existing loans aggregating $15,500,000, which had been made at least six months before the pledge of Elsters stock.

readily ascertainable market value" (P 17, n.12). It is self-evident that if the basic element of a securities case is misrepresentation or omission as to a security, federal jurisdiction can hardly depend on whether the stock pledged is that of a large publicly-held company or "a small, nonpublic company."

We know of no case which has held that the "in connection with" requirement is satisfied, with consequent jurisdiction under the securities laws, where securities were pledged as collateral for a bank loan and there was no averment of misrepresentation or omission regarding the pledged securities. As the court of appeals stated, "all the cases imposing liability for violations of § 17(a) of the 1933 Act or § 10(b) of the 1934 Act or Rule 10b-5, in respect of pledges, are cases where the defendant committed a proscribed act with respect to the pledged securities" (29a).

Where there is no averment of misrepresentation or omission regarding the pledged securities, the courts have consistently held that the "in connection with" requirement of Rule 10b-5 is not satisfied. *See, e.g., McClure* v. *First National Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Dopp* v. *Franklin National Bank*, 374 F. Supp. 904 (S.D.N.Y. 1974).[11]

The Banks' principal thrust appears to be that the court of appeals decided a federal question, namely, the scope of the "in connection with" provision, in a way in conflict with *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). Petitioners charge the court of appeals with "regressing to its own more restrictive view that the fraud must relate to the value of the security (here, the pledged stock)-- the same test rejected by this Court in *Superintendent*" (P 14). Indeed, the petition reiterates that the court of appeals has now established a

11. As explained in Comment, *The Pledge and the Purchase and Sale Requirement of Section 10(b) and Rule 10b-5*, 65 Geo. L. J. 1593, 1617 (1977), in *McClure* "[t]he pledge of stock for the extension of the note was, if anything, only incidental to the fraudulent loan transaction. The claims in *Dopp* and *McClure* can be contrasted with the fraud claims in *Mallis* [v. *Federal Deposit Ins. Corp.*, 568 F.2d 824 (2d Cir.), *cert. granted*, 431 U.S. 928 (1977), *cert. dismissed as improvidently granted*, 435 U.S. 381 (1978) (per curiam)] and *Lincoln National Bank* [v. *Lampe*, 414 F. Supp. 1270 (N.D. Ill. 1976)], where the fraud was related directly to the purchase or sale of a security."

"new rule of law," namely, that federal jurisdiction does not exist as to the pledge of a security where there is "no direct misrepresentation as to the value of the . . . pledged securities" (P 7-8), and that there cannot be a Rule 10b-5 case "unless the alleged fraud related directly to the value of the securities in issue" (P 13; also 14, 18, 20). The petition further charges the court of appeals with "[d]isregarding the broad 'touching' test which this Court established in *Superintendent* and demoting that test to a matter of 'literary style' (31a)" (P 6);[12] with having "created a direct conflict with *Superintendent*" (P 7), where "the alleged fraud did *not* relate to the value of the securities at issue" (*id.*) (italics in original text); and with "purport[ing] to overrule" that case (P 12).

However, the court of appeals did not hold that a cause of action can never lie under the antifraud provisions of the securities laws, absent misrepresentation as to the value of the security. If, as in *Superintendent*, a fraud is "in connection with" the purchase or sale of a security, then Rule 10b-5 would, by its terms, apply. What the court of appeals held was that in this case, unlike in *Superintendent*, the alleged fraud was not "in connection with" the pledge of a security, -- a fact which is self-evident.[13]

Superintendent, which did not involve a pledge of stock as security for a commercial bank loan, does not bear the remotest relationship to the situation at bar. *Superintendent* involved a typical "bootstrap" operation, where control of a corporation is bought by using its own assets. There, the sale of the $4,854,552 of Treasury Bonds owned by the corporation was the device used

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12. The court of appeals simply indicated that it was "inclined to agree with Professor Loss, that 'there is no reason to believe that the Justice's [Justice Douglas] use of "touching" was anything more than his variation of "in connection with" as a matter of literary style'" (31a).

13. While the petition charges the second circuit with setting up a "straw man" "to avoid an appearance of conflict with precedent in other circuits" (P 22, n.17), actually the Banks themselves have set up a straw man by asserting that the second circuit established a rule of law -- which it did not in fact establish -- and then directing its petition to showing that such putative rule of law is contrary to other decisions.

to perpetrate the fraud, since the proceeds of their sale substantially made up the $5,000,000 used to buy the stock of the Manhattan Casualty Co. Without the sale of the Treasury Bonds, the fraud could not have been achieved. Hence, Mr. Justice Douglas stated that the corporation suffered an injury because of fraud "touching its sale of securities" (404 U.S. at 12-13).

The cases which have applied the "touching" test all involved a deceptive practice or scheme to defraud, where the sale of stock was an integral part of the fraud and was essential to its effectuation. Indeed, 5A Jacobs, *Litigation & Practice Under Rule 10b-5* (2d ed. 1981), upon which petitioners rely to support their position that the "in connection with" clause is "fulfilled if a securities transaction is involved in some way, even though the fraud did not occur in the purchase or sale that is attacked," states that this assumes that "the fraud and securities transaction can be integrated into the same scheme" (*see* P 12, n.9). But as the court of appeals below noted, the Banks' effort to "integrate" the pledge of Elsters stock in August 1977 with Andersen's May 10, 1977 opinion on Frigitemp's December 31, 1976 financial statements amounts only to a claim of "'but-for' causation" (34a), which is "not enough" (*id.*).[14]

The court of appeals correctly held that "while the pledge of the Elsters stock was a sale of a security by Frigitemp and a purchase by the Banks, Andersen's alleged misrepresentations concerning Frigitemp (but not Elsters) were not in connection with the sale or purchase of the Elsters stock under § 10(b) of the

14. The Banks assert (P 20-22) that *United States* v. *Kendrick*, 692 F.2d 1262 (9th Cir. 1982), *cert. denied*, 103 S. Ct. 1892 (1983); *McGrath* v. *Zenith Radio Corp.*, 651 F.2d 458 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981); *Brown* v. *Ivie*, 661 F.2d 62 (5th Cir. 1981), *cert. denied*, 455 U.S. 990 (1982); and *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979), are in "serious conflict" with the decision below. But none of these cases involved a pledge of stock as security for a commercial bank loan where there was no misrepresentation as to the stock pledged. The opinion below considered "the many cases relied upon by the Banks" and held that none of them "goes as far as they [the Banks] would take us here" (34a). Indeed, petitioners' own summary of these cases shows their inapplicability (P 20-22).

1934 Act and Rule 10b-5 issued thereunder or in the offer or sale of a security under § 17(a) of the 1933 Act" (36a-37a).

III.

THE OPINION OF THE COURT OF APPEALS IS NOT IN CONFLICT WITH THIS COURT'S RULINGS CONCERNING THE STANDARDS FOR SUMMARY JUDGMENT.

The Banks argue that the opinion below "ignored facts" and "chose between conflicting facts to rule against the party opposing summary judgment" (P 23). This is not so. The only facts before the court are those presented by the Banks and the documents produced by the Banks in discovery and placed before the court through the affidavit of Andersen's attorney.

The petition does not state which "facts" were ignored below, other than the facts establishing that the August 1977 transaction was "'one single, integrated refinancing package'" (10a). However, obviously this assertion was not "ignored," since the opinion quoted this alleged fact and stated that "we shall assume for present purposes that this was the case" (*id.*). All the facts came from the Banks' documents -- a classic case for summary judgment against the party which produced such documents.

Moreover, summary judgment was not granted (P 6, n.6). The complaints were "dismissed" by the court of appeals "for failure to allege violations of the federal securities laws" (37a).

IV.

THE CASE SHOULD HAVE BEEN BROUGHT IN THE STATE COURT.

The Banks complain that now "after years of litigation in federal court, the Banks will be relegated to starting over again in state court, even though this accounting fraud has resulted in a spate of *federal* civil 10b-5 suits against Andersen and Frigitemp officers" (P 10-11) (italics in original text). However, the Banks had to know at the outset that federal jurisdiction was highly questionable. The Banks, which filed their first complaint on May 11, 1979, have never explained why they preferred to spend over

five years litigating their dubious right to be in federal court on a common law claim, instead of the state court.[15] The "spate of *federal* civil 10b-5 suits," to which the petition refers, involved Frigitemp's common stock and long-term debentures, clearly securities presenting no issue as to federal jurisdiction.

CONCLUSION

It is respectfully submitted that the petition does not meet any of this Court's criteria for exercising its discretion to grant certiorari; that the court of appeals decision is correct in all respects; and that certiorari should be denied.

Respectfully submitted,

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September 14, 1984

15. *See, e.g., Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 174 N.E. 441 (1931); *State Street Trust Co.* v. *Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938).

APPENDICES

APPENDIX A

Excerpts from documents produced by the Banks

FRIGITEMP CORP.

SEPTEMBER 29, 1971

Joseph Heilbrun, supposedly an officer of Frigitemp, asked me to consider a $500M line for O/P and/or B/R's. Since Heilbrun was with Sampson International (Prospect File), and Strauss DuParquet (Bankrupt) we have investigated Frigitemp thoroughly. The result is a borrowing relationship at Branch #3. If Mr. Heilbrun again requests our assistance we will suggest that he go to the Branch where the borrowing relationship already exists.

H. A. Knox/mb

FRIGITEMP CORPORATION 0-74421

June 24, 1977

As a result of the banks' suggestion, Frigitemp contracted with Worden & Risberg, management consultants, for a review of the cash flow projections and management procedures. We have received the report and it substantiates Frigitemp's need for $4MM on an almost immediate basis. The trade has begun to hold shipments and Pete Bohn of Worden & Risberg feels that a doling out of the $4MM on a proper basis would open up the flow of shipments from suppliers. The banks met with the company on June 21st and presented a draft of a proposed loan agreement prepared by Simpson Thacher & Bartlett which allows for the extension of the present secured loan agreement and the additional extension of $4MM taking new security interests. The banks would receive an assignment of Elsters stock, the Litton claim and the excess notes receivable to run to the new $4MM

and the already existing $9MM of O/P notes. We would, of course, need Equitable's approval. Because the cash flow projections run only to 12/31/77 it was also proposed that the agreement mature on that date to which the company strenuously disagreed, contending that the timing pressures at year end would be excessive. Security Pacific remained steadfast in its resolve not to extend the Termination Date beyond June 30th. This decision will add to the company's cash flow problems since approximately $2.5MM net new money was factored into the cash flow. Frigitemp has proposed to borrow this money from Aetna against future notes, a point which is being discussed among the banks.

The meeting ended with all parties resolved to review the proposed loan agreement and obvious differences of opinion with respect to solving the cash flow needs although all parties seem to recognize the urgency to some extent.

----------J. H. Brown----------

CHEMICAL BANK interoffice

To: Joe Eyring, Loan Workout Date: May 22, 1978

From: Dennis A. Gewant, AVP - CD 2 Tel. Ext. 1816

Subject: Frigitemp Corporation's claim against Litton

As you are aware, in November, 1976 I personally called Mr. Lagonegro who is Vice President in charge of contracts at Litton's Ingalls shipyard, at the request of Joe Heilbrun to confirm what Joe Heilbrun described as a final settlement on $17 million worth of claims Frigitemp had against Litton which we were told would result in a $11 million final payment to Frigitemp on or before February 28, 1977. This confirmation was to be made for the purpose of accommodating Frigitemp's request for a $4 million loan, the pay out of which will be the proceeds of this final settlement. Mr. Lagonegro indicated that he would confirm this final settlement with a memorandum of understanding which in itself is not a firm commitment of the settlement but will outline

the details of what Litton did indicate as definitely being a firm settlement. In March, we became aware of the fact that this payment would not be made and what Mr. Heilbrun informed us of is the fact that when the $11 million check was presented to Mr. O'Green, the Chief Executive Officer of Litton, he cancelled the check when he found out that this claim settlement was not in fact, under the terms of Litton's contract with the Navy but in fact would result in a claim against the Navy. His thinking, we were told, is that when they get reimbursed by the Navy they would then eventually pay this amount to Frigitemp if in fact they recover a similar amount from the Navy. This, of course, is in total contradiction to the firm commitment given to the writer by Mr. Lagonegro. We are now all familiar with subsequent events concerning Frigitemp and its financial difficulties. I have attached a copy of the white sheet in which I described the details of my conversation with Mr. Lagonegro. I have also attached a copy of the memorandum agreement which followed my conversation with Mr. Lagonegro which you will note is unsigned. In addition, I have attached a letter signed by Mr. Lagonegro acknowledging substantial liabilities by Litton to Frigitemp. It is my position that this may be an appropriate time to pursue this matter with possible contact made with Litton Industries.

Concerning my conversation with Mr. Lagonegro, in that before a final plan of reorganization is adopted by the courts under Frigitemp's Chapter 11 proceedings, we should make an effort to see if some type of settlement can now be reached with Litton in that any monies derived from this endeavor may be the only hope for the rejuvenation of Frigitemp as an on-going concern.

I would, therefore, like to arrange a meeting as quickly as possible between you and those copied in this memorandum as well as Bill Silverman from the law firm, Otterbourg, Steindler, Houston & Rosen, to determine what posture should be taken in this matter, at this time. I believe it is important that this meeting be arranged immediately to effect a final determination.

cc: J.B. Mencke
D.F. Rithcie
R. Vandermark
D. Weisbecker

APPENDIX B

Excerpts from Chemical Bank's Answers and Objections to Andersen's Interrogatories Relating to Subject Matter Jurisdiction

79 Civ. 2464 (GLG)

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

CHEMICAL BANK,

Plaintiff,

-against-

ARTHUR ANDERSEN & CO., GERALD LEE, MERVYN SILVER, JOSEPH HEILBRUN AND JOHN DOES, NUMBERED ONE THROUGH TWENTY, THE LATTER BEING FICTITIOUS NAMES,

Defendants.

PLAINTIFF CHEMICAL BANK'S ANSWERS AND OBJECTIONS TO DEFENDANT ARTHUR ANDERSEN'S INTERROGATORIES RELATING TO SUBJECT MATTER JURISDICTION

Plaintiff Chemical Bank ("Chemical") responds to Arthur Andersen & Co.'s ("Andersen") Interrogatories To Plaintiff Relating To Subject Matter Jurisdiction ("Interrogatories") as follows:

* * * *

Interrogatory #13

State whether plaintiff contends that it determined that it would not have extended credit to Elsters, Inc., as averred in paragraph 17(c) of the Complaint, but for the Pledge Agreement referred to in such paragraph and, if so, set forth the basis for plaintiff's contention and identify each document which refers or relates to such determination or the basis for such contention.

Answer to Interrogatory #13

Yes. It is the opinion and recollection of Chemical personnel involved in Transaction #3 that plaintiff would not have extended credit to Elsters, Inc. but for the pledge of stock to secure Frigitemp Corp.'s guarantee of the loan. (See Gewant memorandum to Credit Committee, August 8, 1979, documents #368, 370, 479-480, 532, 721. See also, documents # 376, 1121, 1123, 505, 543.)

Moreover, the circumstances surrounding the transaction fully support that view:

1. Banks commonly take the stock of a company as collateral in order to obtain additional protection;

2. In light of the increasing financial difficulties of Frigitemp, guarantor of the loan (and parent company of Elsters), Chemical wanted to ensure that the loan to Elsters and the accompanying guaranty by Frigitemp was supported by sufficient security. Based on available information, Elsters was considered to be a healthy and viable company, one of the strongest of Frigitemp's assets, which could be sold as a going concern in the event of a default by Frigitemp on its guaranty. Thus, the stock of Elsters was viewed as valuable. In addition, it was felt that, in the event of default, recovery realized on the foreclosure and sale of the equity would be higher than that realized on piecemeal foreclosure and sale of various assets of Elsters.

3. Because of the existing liens on Frigitemp's other assets (in favor of Equitable), the stock was necessary to secure Frigitemp's guaranty of the loan;

* * * *

Dated: New York, New York
April 1, 1980

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By /s/ D. ROBERT OWEN
A Member of the Firm

TO:
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-and-

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APPENDIX C

Promissory Note from Frigitemp Corp. to Chemical Bank, dated August 9, 1977

$2,655,000 — New York, New York
August 9, 1977

FOR VALUE RECEIVED, FRIGITEMP CORP. promises to pay to the order of CHEMICAL BANK (the "Bank") at its offices located at 20 Pine Street, New York, New York, in lawful money of the United States of America, the principal amount of TWO MILLION SIX HUNDRED SIXTY-FIVE THOUSAND DOLLARS ($2,655,000) on or before March 31, 1978. The undersigned also agrees to pay interest at said office, in like money, from the date hereof on the unpaid principal amount hereof at a rate per annum equal to 110% of the sum of (a) the Prime Rate of the Bank from time to time in effect plus (b) two per cent (2%), provided that whenever any unpaid principal of this Note shall become due and payable (whether at the stated maturity, by acceleration or otherwise), interest on the unpaid principal amount thereof shall thereafter be payable at a rate per annum equal to 110% of the sum of (a) the Prime Rate of the Bank from time to time in effect plus (b) three per cent (3%) until such amount shall be paid. As used herein, the "Prime Rate" shall mean the commercial loan rate of the Bank from time to time in effect at its principal office on ninety day loans to its most responsible and substantial domestic corporate borrowers. Any change in the interest rate resulting from a change in the Prime Rate shall become effective as of the opening of business on the date on which such change in the Prime Rate shall occur. Interest shall be payable quarterly on the last business day of March, June, September and December in each year, commencing on September 30, 1977, and upon payment in full of the unpaid principal amount hereof.

This Note is one of the Replacement Notes referred to in a Note Replacement Agreement, dated as of August 8, 1977, among the undersigned, the Bank and the other banks party

thereto and Manufacturers Hanover Trust Company, as agent for such banks, and is entitled to the benefits thereof; this Note may be prepaid in whole or in part as provided therein and is subject to mandatory prepayment in whole or in part under certain circumstances as provided therein.

Upon the occurrence of any one or more of the Events of Default specified in said Note Replacement Agreement, all amounts then remaining unpaid on this Note may be declared to be immediately due and payable as provided in said Note Replacement Agreement.

FRIGITEMP CORP.

By /s/
Title: